OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: GIFT TAX VALUATION ON FORMATION OF FAMILY LIMITED PARTNERSHIP

This Field Service Advice responds to your memorandum dated June 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Donor H:	=
Donor W:	=
x:	=
y:	=
Date 1:	=
Year 1:	=
State:	=
$a:	=
$b:	=
Month 1:	=
Month 2:	=
Year 2:	=
g1:	=
g2:	=
d1:	=

ISSUE:

Did the donors make taxable gifts in the course of forming, funding, and acquiring limited partnership interests in a family limited partnership during Year 1?

CONCLUSION:

Yes, donors made taxable gifts when, on the formation of a partnership not in the ordinary course of business, the donors took back partnership interests with a value less than that of the assets contributed in exchange therefor.

FACTS:

Donor H was x years of age and Donor W was y years of age on Date 1, Year 1, the date they formed a family limited partnership with their two sons under the laws of State. The two sons held the one percent general partnership interest through a management trust formed for this purpose. The donors each contributed over $a in marketable securities to the partnership while the sons contributed a promissory note in excess of $b, which was eventually paid.

Between Month 1 and Month 2 of Year 2, Donor H and Donor W each gifted a g1 percent interest in the family limited partnership to two trusts, one benefitting the first son and a second trust benefitting the other son. Donor H and Donor W filed separate U.S. Gift Tax Returns, Form 709, for Year 2, reporting individual combined gifts of a g2 percent interest in the family limited partnership to each trust. In valuing the gifts of the family partnership interests, Donor H and Donor W discounted the fair market value of the partnership assets over d1 percent for lack of marketability and minority status.

Donor H and Donor W also filed separate U.S. Gift Tax Returns, Form 709, for Year 1, reporting gifts unrelated to the family limited partnership. Upon examination, the Internal Revenue Service determined that one or more of the transfers made by Donor H and Donor W in the course of forming, funding, or acquiring units or interests in the family limited partnership during Year 1 was taxable as a gift.

LAW AND ANALYSIS

We agree with the analysis set forth in your field service advice request, in which you concluded that, when the transaction is viewed as a whole, it is clear the donors acted in a donative manner, taking back partnership interests allegedly worth significantly less than the assets transferred, all in an effort to enable the other partners, directly or indirectly, to realize the full value of the underlying assets at some future date.

You should be aware of three potential counter arguments to the gift on formation theory, made when the partnership interests received by each of the partners are

proportionate to the partnership contributions each made. The counter arguments are: (1) No gift occurs on formation because a partnership interest represents a proportionate interest in all of the property transferred to the partnership, i.e., any difference between the value of the property transferred and the interest received occurs as a consequence of formation, and does not enhance the value of another partner's interest; (2) If the formation of a family entity results in a gift, then all of the family members have made gifts because the interest each receives is generally worth less than the assets contributed to the partnership; and (3) The inability to identify the donees throws into question whether a transfer has occurred in the first place.

The appropriate responses to the counter arguments are as follows. (1) Where an older generation partner takes back only a limited partnership interest, he has not really received a proportionate interest, for he has given up the element of control. (2) When the transaction is viewed as a whole, it is clear that the donor is acting in a donative manner, taking back a partnership interest worth less than the assets transferred to enable the donee partners to realize the full value of the underlying assets at some future date. With respect to the management trust, the transaction is one in the ordinary course of business. The management trust is entering the transaction to ultimately acquire additional assets, and not to transfer value to the other partners. The management trust does not make a gift because it has no donative intent. Rather, its participation is designed to facilitate the donor's transfer to it and the donee partners. Thus, with respect to the management trust, the transaction is a business transaction, exempt from gift tax. (3) Finally, once it has been shown that the formation of the partnership was not a bona fide business transaction, section 2512 statutorily determines the amount of the gift as the difference between the value transferred and the value received, an amount which does not reflect a discount for the existence of the entity. Identification of the donee is not necessary. All that must be established is that the transfer was not one in the ordinary course of business and that the donor relinquished property for less than adequate consideration. The facts will clearly show that the donors' transfer of value will be manifested in a transfer tax savings inuring to the donee partners.

Finally, while we agree with your analysis, you should be aware of the other primary theories generally asserted. The other primary theories pertain to the value of the transferred interest and the availability of any discount (in Year 2 in this case). The arguments are as follows: (1) the partnership lacked economic substance and thus the partnership form should be disregarded, (2) the partnership lacked a business purpose and thus the partnership form should be disregarded, and (3) section 2704 applies and thus the value of the interest is determined without regard to certain restrictions on the ability to liquidate. An overview of the above theories follows.

1. Substance over form.

It is clear that, for the purposes of federal taxation, the courts may completely disregard the form of a transaction if it is found to lack economic substance. This doctrine originates from the opinion of Gregory v. Helvering, 293 U.S. 465 (1935). There the Supreme Court held that an otherwise valid corporate formation and subsequent reorganization could be disregarded when the substance of those transactions was to avoid tax on a transfer of stock. The Supreme Court later employed similar reasoning in disregarding the otherwise valid purchase of certain bonds and subsequent use of them as loan collateral, in Knetsch v. United States, 364 U.S. 361 (1960). There it found that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction," (attributable to alleged interest deductions). Knetsch, 364 U.S. at 366.

An overview of the relevant inquiry in the substance over form analysis was set forth by the Third Circuit in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999).

> The inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them...[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

Id. at. 247 (emphasis added)(citations omitted).

The first of these two factors focuses on whether the transaction has any practical economic consequences other than the creation of tax benefits, i.e. whether the transaction appreciably changed the taxpayer's financial position. Id. at 248. The second of these focuses on what the taxpayer intended. Id. at 252.

The courts have had no reluctance to find that partnerships themselves lack economic substance. In a recent case from the Fifth Circuit, the court agreed that a partnership, ostensibly engaged in the actual operation of an oil rig, nevertheless lacked economic substance and could be disregarded. Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989). Once the partnership was disregarded, various tax benefits of the partnership, including losses and credits were disallowed. Some of the factors relied upon by Merryman included (1) a pattern of "interconnected ownership of the partnership and related entities," (2) a failure of all the partners to contribute capital, (3) a lack of arms length transactions, and (4) little evidence of the existence of the partnership. Where a partnership owns no property, maintains

no books or records, and does not hold itself out as being engaged in business, there is little evidence of the existence of the partnership and accordingly, a lack of economic substance. Merryman, supra at 883; Cirelli v. Commissioner, 82 T.C. 335, 346-47.

The Tax Court applied an economic substance analysis in Estate of Murphy v Commissioner, T.C. Memo. 1990-472, 60 T.C.M.(CCH) 645, where the issue was federal transfer taxes. In Estate of Murphy, the court disregarded, for estate and gift tax purposes, a legitimate transfer of property, because it found that the substance of the transaction was to generate a minority discount for transfer tax purposes. The transaction at issue there was Mrs. Murphy's transfer, just before her death, of just enough of her closely held stock to her children so as to reduce the size of the remainder of her stock to an amount slightly less than 50 percent of the total outstanding stock. Thus, her estate claimed a minority discount for the stock she retained at her death. The court in Estate of Murphy focused on the decedent's subjective intentions (to obtain a minority discount) and the objective economic facts (she nevertheless retained effective control of the closely held corporation). It specifically cited the rationale of Gregory v. Helvering, supra, and Knetsch v. United States, supra, and held:

> The same rationale applies in the cases before us. Here, we conclude that decedent's two small lifetime gifts of [the closely held stock] do not appreciably affect decedent's beneficial interest except to reduce Federal transfer taxes.

Estate of Murphy, supra at 661.

2. Business purpose.

The lack of business purpose argument involves a completely separate line of cases, amounting to another doctrine, that essentially compels the same result in any case where a partnership lacks a business purpose. These are the progeny of Commissioner v. Tower, 327 U.S. 280 (1946). See, e.g. ASA Investerings v. Commissioner, T.C. Memo. 1998-305, and Vanderschraaf v. Commissioner, T.C. Memo. 1997-306, and the cases cited therein.

In Tower, the court held that state partnership laws do not control whether a partnership will be recognized for federal tax purposes. The issue there was the validity of a limited partnership formed by a husband and wife that complied with Michigan state law. The court famously defined a partnership for federal tax purposes as occurring when:

> persons join together their money, goods, labor, or skill *for the purpose of carrying on a trade, profession or business* and when there is a

> community of interest in the profits and losses. The partners' intention to join together for the purpose of carrying on business and sharing in the profits or losses is a question of fact.

Tower at 286 (emphasis added).

In the Tower case, the Supreme Court found the facts to be that the taxpayer-husband continued to manage, control and run the business and that he continued to have funds at his disposal to use in the business or to expend for family expenses. The taxpayer-wife did not contribute her services and took no part in the management or operation of the business. Because of these facts, the Supreme Court in Tower sustained the determination that the partnership brought no real change in the economic relation of the husband and wife to the income in question.

The Supreme Court revisited the question in the case of Commissioner v. Culbertson, 337 U.S. 733 (1949). Again confronted with a family partnership, the Court refined certain points of its analysis, but still retained the point being urged here:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent--the parties *in good faith and acting with a business purpose* intended to join together in the present conduct of the enterprise."

Culbertson at 742 (emphasis added).

If the partnership is disregarded for federal transfer tax purposes under either lack of economic substance or lack of business purpose theories, and the claimed discount is based on attributes of the partnership, it follows that no discount at all would be allowed in the valuation of the partnership interests transferred.

3. Section 2704.

Section 2704 may reduce the size of the claimed discount by requiring the expert to disregard for valuation purposes certain restrictions in the partnership agreement. The expert must disregard for valuation purposes any "applicable" restriction when an interest in a partnership is transferred to or for the benefit of a family member of

the transferor, and immediately before the transfer, the transferor and members of his family control the partnership.[1]

An "applicable restriction" is a restriction that limits the ability of the partnership to liquidate and that either is removable by the transferor or members of his family after the transfer, either alone or collectively, or lapses at any time after the transfer. Treas. Reg. § 25.2704-2(b). An applicable restriction includes any restriction on liquidation that is more restrictive than state law, but does not include restrictions that are commercially reasonable or imposed by state law. Treas. Reg. § 25.2704-2(b); I.R.C. § 2704(b)(3).

If a restriction is disregarded under this section, the transferred interest is valued as if the applicable restriction in the partnership agreement does not exist. Instead, any liquidation rights pertaining to the transferred interest are determined under state law. Treas. Reg. § 25.2704-2(c).

From the facts of this case, it is clear that immediately before the transfer, the Donors and members of Donors' family had control of the partnership as defined in Treas. Reg. § 25.2701-2(b)(5). Thus, in order to determine if section 2704(b) applies to disregard any restrictions in valuing the interest transferred by Donors H and W, the partnership agreement, as well as State law, must be analyzed to ascertain whether the partnership agreement contains restrictions on liquidation which are more restrictive than state law. For instance, a restriction on the ability to terminate, dissolve or withdraw from the partnership may be more restrictive than the law of State, and thus more restrictive than state law. The partnership agreement must also be examined to determine if any applicable restriction is removable after the transfer by family members of Donors H and W. If said restriction meets the requirements of section 2704(b), the transferred interest may be valued as if the restriction does not exist and, therefore, any right to liquidate will be determined under state law.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[1]Section 2704(b) applies to restrictions in both partnerships and corporations, however, for our purposes, we will refer to only partnership restrictions.

[redacted]

Please call if you have any further questions.

By: _____

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